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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-288

GLENN R. HEYMAN, Trustee of the Estate of F. W. KOENECKE & SONS, INC., Bankrupt,
Trustee, Petitioner,

vs.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,
Claimant, Respondent.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the People of the State of Illinois are estopped to recover unpaid taxes because of the corruption, misconduct or negligence of State employees;

2. Whether the perpetrator and beneficiary of a fraudulent scheme to escape lawful taxes may assert the temporary success of that scheme to defeat the People's claim for payment of correct taxes once the scheme has been exposed;

3. Whether the general creditors of a bankrupt taxpayer may defeat the priority of a State tax claim and enjoy the proceeds of a fraudulent tax evasion scheme perpetrated by the bankrupt and delinquent public officials.

STATEMENT OF THE CASE

On March 13, 1969, involuntary bankruptcy proceedings were initiated against F. W. Koenecke & Sons, Inc., then the largest cigarette distributor in Illinois. After Koenecke was adjudicated bankrupt on April 1, 1969, Glenn R. Heyman, Petitioner, was appointed as receiver and trustee for the bankrupt estate.

On April 8, 1969, the Illinois Department of Revenue filed a priority tax claim for $1,268,334.60. This sum represented only a portion of the Illinois Cigarette tax and cigarette use tax which Koenecke defrauded Illinois taxpayers. An additional $800,000 recovery was banned by Illinois statutes.

The Petitioner filed objections which were sustained by the District Court but reversed by a unanimous decision of the United States Court of Appeals. 533 F.2d 1020. From the denial of his petition from rehearing on June 2, 1976, the present action was commenced.

STATEMENT OF FACTS

On April 20, 1976, Messrs. Justices Fairchild, Tone and Bauer rendered their Opinion in the cause at bar. (533 F 2d 1020). It found that:

> The central issue on appeal is whether the State of Illinois is estopped to recover the taxes because of the involvement of state employees in Koenecke's plan to obtain maximum tax discounts through multiple licenses. We reverse. (533 F 2d at 1021)

The Court then held that Illinois taxpayers were *not* estopped to recover due to the illicit participation of state employees in Koenecke's fraud. In reaching this decision, the Seventh Circuit determined that:

> 1) In Illinois a distributor prepays the cigarette tax by purchasing tax stamps and affixing them on the cigarettes to be sold. For its services in purchasing and affixing the stamps, Koenecke was entitled to receive a discount, which up until 1963 was a flat 5% of all stamps purchased. (id., at 1021)
>
> 2) In 1963, . . . the Illinois General Assembly enacted a graduated declining discount schedule to reflect the high volume distributor's decreased cost per revenue stamp affixed. (id., at 1021)
>
> 3) In the case of Koenecke, its volume of cigarettes sales was so high that the purchase of $700,000 in stamps occurred at the end of one week, and the minimum discount bracket was reached in the first three weeks of each year. (id., at 1021)
>
> 4) To circumvent the graduated declining discount formula of the statute and to insure the highest possible discount for its operations, Robert F. Koenecke, the principal shareholder of the bankrupt company, and his wife, filed over 52 multiple license applications as cigarette distributors in the individual names of company employees. (id., at 1021)

5) There is no doubt Koenecke's licensees were mere figureheads and never intended to or did, in fact, engage in the business as distributors of cigarettes. Many of the Koenecke employees, who were presented to the State of Illinois as licensees, denied signing or authorizing Koenecke to sign their signatures to the license applications. (id., at 1022)

6) In our view there is no doubt that the claim presented is for taxes. Although the discount allowed by the State is intended to compensate the distributor for the costs of affixing the stamps, *Heyman v. Mahin, supra,* indicates that the distributor must pay the taxes based on sales after subtracting his discount. The money wrongfully withheld by Koenecke is that amount over and above the allowable discount for compensation of costs of affixing the stamps, i. e., money owed to the State for each tax stamp that was placed on each package of cigarettes distributed. (id., at 1025)

7) In fact employees of the state affirmatively participated in Koenecke's attempt to minimize taxes.[1] The evidence shows that one of the Department of Revenue's auditors actually taught Koenecke personnel how to compute and report the nominal intercompany transfers to and from secondary licensees which were shown on the monthly returns. It was admitted that from time to time Department personnel called Koenecke and other distributors to remind them that it was time to change licenses in order to avoid going over the $700,000 limit.

[1] The record indicates that not all state employees were willing to cooperate with the Koenecke plan. Hildren L. Carney, Supervisor of Liquor & Cigarette Revenue Division, who was immediately responsible for processing and approving license applications, objected to the issuance of multiple licenses. However, he was ordered by his superior to "be a good soldier, or a good boy—and see that these licenses are issued" (Tr. 3/18/74 a.m., pp. 52, 59, 61, 87; Tr. 3/18/74 p.m., pp. 9, 19). (id., at 1022)

8) Other distributors followed Koenecke's multiple license scheme. However, the state contends that the evidence shows that only Koenecke consistently falsified license applications and that the record is barren of evidence that any other licensee was guilty of such flagrant conduct. In addition the state points out that Koenecke avoided over $2,000,000 in unpaid cigarette taxes while the average discrepancy for every other distributor was only $32,000. (id., at 1022)

9) Moreover . . . there is clear precedent that the estoppel doctrine should not apply against the State in revenue matters. *Austin Liquor Mart Inc. v. Dept. of Revenue,* 51 Ill.2d 1, 280 N.E.2d 437 (1972); *Mr. Car Wash, Inc. v. Dept. of Revenue,* 27 Ill.App.3d 931, 327 N.E.2d 88 (1975); *People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.,* 56 Ill.2d 210, 306 N.E.2d 7 (1974). The rationale of these cases is that people of the State should not be denied taxes rightfully owing because of mistakes or collusive fraud on the part of the state employees. (id., at 1023)

10) The creditors of Koenecke, of course, are not being penalized or prosecuted in any way. Their complaints are against Koenecke not the State. Their right to enjoy the illegal fruit of the Koenecke scheme by usurping the unpaid State taxes resulting from the multiple license plan can be no greater than the taxpayer's right to avoid those taxes. (id., at 1025)

Having made these determinations, the United States Court of Appeals held that:

> . . . in this instance we think the bankruptcy judge's conclusion of law #16 was wrong in holding that it would be inequitable for the State to participate on a priority or even equal basis with the other creditors. We believe that the proper view of the facts does not show that the state is profiting

at the expense of the creditors. Rather all the people of the State are benefited when taxes which are lawfully owing are collected. Therefore we are of the opinion that the bankruptcy judge should not have subordinated the State's claim to the claims of general creditors unless the general creditors can establish some type of priority for their claims under the bankruptcy act. (id., at 1024-1025)

From this decision, the present proceedings were commenced.

ARGUMENT

I.

THE COURT OF APPEALS PROPERLY HELD THAT THE PEOPLE ARE NOT ESTOPPED TO RECOVER LAWFUL TAXES WRONGFULLY EVADED BY A FRAUDULENT MULTIPLE LICENSING SCHEME.

In its decision, the court of Appeals held that:

> . . . there is clear precedent that the estoppel doctrine should not apply against the State in revenue matters. *Austin Liquor Mart Inc. v. Dept. of Revenue*, 51 Ill.2d 1, 280 N.E.2d 437 (1972); *Mr. Car Wash, Inc. v. Dept. of Revenue*, 27 Ill.App.3d 931, 327 N.E.2d 88 (1975); *People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.*, 56 Ill.2d 210, 306 N.E.2d 7 (1974). The rationale of these cases is that people of the State should not be denied taxes rightfully owing because of mistakes or collusive fraud on the part of the state employees. (533 F 2d at 1023)

The inapplicability of estoppel doctrine in revenue matters was exhaustively researched in *Austin Liquor Mart, Inc. v. Dept. of Revenue*, 51 Ill. 2d 1, 4-5, 280 N.E. 2d 437, 439 (1972):

> "Plaintiff contends that a 'final assessment' is equally binding on both parties and once the notice of tax liability becomes final and the assessment is paid, defendant is barred from further investigation. We do not agree. It is firmly established that where the public revenues are involved, public policy ordinarily forbids the application of estoppel to the State. *Department of Revenue v. Barding*, 33 Ill. 2d 235; *Skillet Fork River Outlet Union Drainage Dist. v. Central Lumber Co.*, 31 Ill. 2d 312; *People v. Chas. Levy Circulating Co.*, 17 Ill. 2d 168; *Clare v. Bell*, 378 Ill. 128; *People v. Women's*

Athletic Club, 360 Ill. 577; 1 A.L.R. 2d 338.) 'It seems to be universally recognized that, generally, a State cannot be estopped by the acts and conduct of its officers or agents in the performance of the governmental function of collecting taxes legally due. * * * *United States v. Globe Indemnity Co.*, 94 F. 2d 576 (C.A. 2), [cert. den. 304 U.S. 575, 58 S. Ct. 1047] *Olson Constr. Co. v. State Tax Com.*, 12 Utah 2d 42, 361 P. 2d 1112; *Henderson v. Gill*, 229 N.C. 313, 49 S.E. 2d 754; *Michigan Sportservice, Inc. v. Nims*, 319 Mich. 561, 30 N.W. 2d 281; *Claiborne Sales Co. v. Collector of Revenue*, 233 La. 1061, 99 So. 2d 345, *Commonwealth v. Western Md. R.R. Co.*, 377 Pa. 312, 105 A. 2d 336; 31 C.J.S., Estoppel, sec. 138; 19 Am. Jur., Estoppel, Sec. 166; Bigelow, Estoppel (6th Ed.), p. 372; 1 Cooley Taxation, p. 159. Cf. *Gontrum v. Mayor & City Council of Baltimore*, 182 Md. 370, 35 A. 2d 128." (*Comptroller of Treasury v. Atlas General Industries*, 234 Md. 77, 198 A. 2d 86, 90.) 'The government is not estopped by previous acts or conduct of its agents with reference to the determination of tax liabilities or by failure to collect the tax, nor will the mistakes or misinformation of its officers estop it from collecting the tax. *State Tax Commission v. Johnson*, 75 Idaho, 105, 269 P. 2d 1080; *Fitzpatrick v. State Tax Commission*, 15 Utah 2d 29, 386 P. 2d 896; *Tennessee Trailways, Inc. v. Butler*, 215 Tenn. 136, 373 S.W. 2d 201; *Good Will Industries of Southern Calif. v. Los Angeles Co.*, 117 Cal. 2d 19, 254 P. 2d 877; *Claiborne Sales Co. v. Collector of Revenue*, 233 La. 1061, 99 So. 2d 345; *Duhame v. State Tax Commission*, 65 Ariz. 268, 179 P. 2d 252.' *State v. Adams*, 90 Idaho 195, 409 P. 2d 415, 419; 31 C.J.S., Estoppel, sec. 147."

See also *Mr. Car Wash, Inc. v. Department of Revenue*, 27 Ill. App. 3rd 931, 327 N.E. 2d 88, 90-91 (1975) where the court most recently held:

> "Although the record indicates that the Chicago office of the Department made a mistake in allowing the deduction, this does not estop the Department from collecting revenues rightfully belonging to the State merely because plaintiff relied on the prior audit in continuing to take the .05 deduction."

As the court explained in *Comptroller of Treasury v. Atlas General Industries*, 234 Md. 77, 198 A. 2d 86, 90 (1964):

> "The reason for the rule is obvious: no administrative officer is vested with the power to abrogate the statute law of the State, nor to grant to an individual an exemption from the general operation of the law."

See also *United States v. Davenport*, 297 F. 2d 284, 285 (CA 4, 1961).

Article IX, Section 6 of the 1870 Illinois Constitution, in effect at the time of the Koenecke tax fraud, provides:

> "The general assembly shall have no power to release or discharge any county, city, township, town or district whatever, or the inhabitants thereof, or the property therein, from their or its proportionate share of taxes to be levied for state purposes, nor shall commutations for such tax be authorized in any form whatsoever."

The Illinois Supreme Court has consistently ruled that if the General Assembly cannot release or commute tax liability, neither can an executive or administrative officer do so. *Massell v. Daley*, 404 Ill. 479, 484, 89 N.E. 2d 361 (1950); *People ex rel. Ames v. Marx*, 370 Ill. 264, 269, 18 N.E. 2d 915 (1939).

This principle has been preserved in Article IX, Section 1 of the 1970 Illinois Constitution.

In *Utah Power & Light Co. v. United States*, 243 U.S. 389, 409, 37 S. Ct. 387, 61 L. Ed. 791 (1916), the United States Supreme Court considered and explicitly rejected the petitioner's rationalizations.

> As presenting another ground of estoppel it is said that the agents in the forestry service and other officers and employees of the Government, with knowledge of what the defendants were doing, not only did not object thereto but impliedly acquiesced therein until after the works were completed and put in operation. This ground also must fail. As a general rule laches or neglect of duty on the part of officers of the Government is no defense to a suit by it to enforce a public right or protect a public interest.

It does not take great imagination to calculate the incentive for corruption if taxpayers could escape tax liability in the millions of dollars by the fortuitous collaboration of government agents in the collection of a tax.

The Court of Appeals stated that:

> We are persuaded primarily by the Chicago Thoroughbred Enterprises decision [56 Ill 2d 210, 306 NE 2d 7 (1974)] . . . which is strikingly similar to the issues and facts presented by Koenecke's multiple license plan to defeat the graduated formula for cigarette tax collections. (id., 533 F 2d at 1023)

The *Chicago Thoroughbred Enterprises* case had its inception in the same Kerner-Isaacs administration which spawned the Koenecke fraud. [See *United States v. Kerner & Isaacs*, 351 F. Supp. 1323; 364 F. Supp. 895; 493 F. 2d 1124, 417 U.S. 976; 418 U.S. 955]

Two years after the General Assembly enacted the graduated discount formula for cigarette tax collections, it similarly adopted a graduated horse racing privilege tax to replace a prior flat rate tax. [Ill. Rev. Stats. 1965, Chap. 8, § 37J1] As with Koenecke, C.T.E. was the largest horse racing licensee in the State, and was the only Illinois operator to fall within the maximum rate of the new graduated tax schedule.

Because of its size and volume of operations, by dividing itself into two purported racing divisions and obtaining two separate licenses, C.T.E. was able to avoid taxes averaging $750,000 per year.

As with Koenecke, the State officials responsible for issuing licenses, and for daily calculating and collecting the taxes due, permitted the multiple license scheme to exist without protest until it was publicly exposed five years later. By the time an independent suit was filed by the Illinois Attorney General, the total amount of unpaid horse racing privilege taxes had accumulated to $4,937,-687.21 for the period 1966 through 1971.

As in the case at bar, the taxpayer first contested the constitutionality of the graduated tax, and then argued that the State was estopped to retroactively recompute the tax due.

As in the case at bar, the taxpayer argued that its corporate operations and the use of designated racing divisions were well known to State officials and were unchallenged throughout the period in dispute.

As in the case at bar, the taxpayer argued that the State actually provided its own inspectors at the track who had verified the tax figures and accepted the tax payment for each racing day without objection.

As in the case at bar, the taxpayer argued that it never even received 44% of the monies in dispute which were immediately distributed as purses to the horsemen participating in the daily races, and, further, that the corporate ownership had been subsequently purchased by the present management in reliance upon public and company books and records and balance sheets showing no outstanding tax liability.

Despite the truly extraordinary circumstances of the C.T.E. case, and despite the active participation and approval of State officials in every phase of the multiple licensing scheme, and despite the compelling equitable arguments advanced by the taxpayer, and contrary to the lower court herein, the Illinois Supreme Court said: "That State inspectors performed the ministerial acts of computing the tax due under one particular formula does not estop the State from repudiating that formula." and entered judgment in favor of the People of the State for $4,937,687.21 and in a companion case ordered the release to the State of an additional $642,968 from a protest fund established for 1972 taxes.

It should be especially noted in the case at bar, that notwithstanding the highly suspicious facts adduced in evidence, neither the Trustee-Appellee nor the court explored the possible improper motivation for Revenue Director Isaacs and Assistant Director Hulman to aid and abet the Koenecke scheme as they did. The State of Illinois most certainly had no public purpose in acting to administratively repeal the new graduated discount statute and releasing over $2,000,000 of tax revenue for the benefit of Koenecke.

The trustee-appellee made no showing that the wrongful acts of Isaacs and Hulman were a legitimate exercise of administrative discretion, and the Bankruptcy Judge and District Court found otherwise.

Thus, it is respectfully submitted that this is clearly a case of breach of public trust where the vital interests of the People of the State must be aggressively protected by the courts and not undermined by misdirected efforts to invoke inappropriate principles of estoppel.

II.

THE COURT OF APPEALS RIGHTLY HELD THAT THE PERPETRATOR AND BENEFICIARIES OF A FRAUDULENT TAX EVASION SCHEME ACQUIRE NO EQUITABLE RIGHT TO ENJOY THE PROCEEDS OF A FRAUD.

In the trustee's Petition for Certiorari, it is argued at page 16 that ". . . the only true distinction between Koenecke's case and all the others [cigarette distributors] is in the dollar amounts involved." It is respectfully submitted that this conclusion is

> drawn from pure speculation as to facts de hors the record. There was no evidence introduced that other cigarette distributors initiated the scheme and forged signatures on 36 license applications, as Koenecke did, or that any other distributor engaged in a scheme of the magnitude and pervasiveness as the one devised by Koenecke. (Tr. 10/14/69 P.M., p. 56) or did any more than avail themselves of a good thing.

Moreover,

> there is no merit or support in the record for the unsupported suggestion that Koenecke hadn't really profited from the more than $2,000,000 taken from the State, because he merely passed the tax savings along in the form of lower cigarette prices.
>
> In the first place, the actual testimony of Koenecke, without quantification, was that he had in fact pocketed part of the tax fraud proceeds. (Tr. 3/21/74 A.M. p. 5) Further, the court may take judicial notice that it is established business practice to balance lower product markups against the concomitant increase in sales volume, i.e. charge less, sell more and maximize profit.

Thus, the Court of Appeals stated:

> No claim has been filed for additional unpaid taxes, estimated to be $800,000, for the two year period from July 16, 1967 to June 30, 1965, for which

recovery is barred by statute (Ill.Rev.Stats. 1973, Ch. 120, § 444). (id., p. 1022)

Consequently, Koenecke has enjoyed use of the aforesaid $2,000,000 during a period when prime interest rates were reaching historic high levels, and the value of the money was actually additionally enhanced by the tight money market conditions.

In *People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.*, 56 Ill. 2d 210, 220-221, 306 N.E. 2d 7, 13, the court said:

". . . we must reject C.T.E.'s argument that a substantial portion of the track commission which remained after taxes . . . was paid over to the owners of the horses running in the meet, and that there is . . . no method by which the excess received by the owners may be recovered by C.T.E. While this would be of importance in a typical claim of estoppel, it cannot be considered when the doctrine of estoppel is inapplicable, as it is here."

Thus, the creditors of a temporarily successful wrongdoer cannot acquire any "equitable" right to rely on the wrongdoer's continued and undisturbed enjoyment of the proceeds of his fraud. It is the Illinois taxpayers who must be entitled to equity as the true victims of Koenecke's fraud.

The trustee has also suggested that the Respondents claim is not for taxes (Petition, pp. 21-22). This assertation is similarly without merit. The monies not lawfully withheld as an allowable discount are, without doubt, cigarette taxes. The distributor's obligation to pay the cigarette tax cannot be avoided. See e.g. *In Re Martin*, 75 F. 2d 618, 620 (CA 7, 1935); *In Re Mid America Co.*, 31 F. Supp. 601, 604 (S.D. Ill. N.D. 1939); *In Re Wm. Ashers, Jr., Co.*, 121 F. 2d 846, 850 (CA 3, 1941); *In Re Otto F. Lange Co.*, 159 F. 586, 588 (N.D. Iowa E.D. 1908).

In *In Re Jim Clay Tobacco Co., Inc.*, 335 F. Supp. 274, 276-277, 280 (N.D. Ga. 1973), involving a state claim in bankruptcy to recover unpaid Georgia cigarette taxes, the Court said:

"The conjunction of state and federal law make the conclusion mandatory that the Georgia Cigar and Cigarette Tax is levied against the distributor as a tax. Under the clear wording of the state act, as interpreted by the Georgia Court of Appeals, there is no *doubt that the distributor's liability is absolute, without regard to whether or not he is able to pass on the economic burden to his retail distributors and the ultimate retail consumers.* If the cigarettes are destroyed in a fire before the ultimate retail sale, while in the hands of a retail distributor, or if the retail distributor becomes a bankrupt, the distributor's obligation is nevertheless fixed. *Inability to collect from his vendees clearly does not absolve the distributor of the burden to pay* . . . (Emphasis added)

And the court further quotes with favor from *Blackman v. Coastal Service, Inc.*, 125 Ga. App. 28, 186 S.E. 2d 441 (1971):

"It being clear from the Georgia Cigar and Cigarette Tax Act, taken as a whole, that the liability of the distributor is fixed and absolute the moment he comes into the possession of cigarettes for the first time, the Court has no alternative but to find the obligation of the Bankrupt to the State . . . to be that of a tax liability. As a tax liability, the State would be entitled to a fourth priority claim under Section 64(a)4 of the Bankruptcy Act, and the objection of the Trustee to the claim is denied."

Given these decisions, the Court of Appeals was unquestionably correct in its rejection of the Petitioner's assertions.

III.

IT IS CONTRARY TO SOUND PUBLIC POLICY TO PERMIT WRONGDOERS TO ENJOY THE FRUITS OF THEIR FRAUD.

The greatest deterrent to tax fraud adventures is the certain knowledge that administrations will change and that no mistake or misunderstanding, no collusion or bribery can guarantee permanent success of the scheme and operate to defeat the People's right to collect lawful taxes once the fraud has been uncovered.

The fraudulent tax evasion scheme in the case at bar was able to exist with the imprimatur of the then Revenue Director, Theodore Isaacs, whose period of stewardship in public office was an unmitigated disaster.

In addition to his indictment and conviction for conspiracy, bribery and perjury [493 F. 2d 1124 (CA 7, 1974)], Isaacs had also been indicted for conflict of interests in negotiating contracts between the State and a private printing company in which he held financial interest. Although the indictment was quashed and dismissed, (*People v. Isaacs*, 37 Ill. 2d 205, 226 N.E. 2d 38 1967)) as a consequence, two justices of the Illinois Supreme Court were required to resign (In the Matter of the Special Commission in Relation to No. 39797) and the original trial judge was eventually suspended from the practice of law (Sup. Ct. No. 45998). Isaacs was also involved in the proceedings surrounding the multi-million dollar failure of the City Savings and Loan Association [*Tcherepnin v. Franz*, 64 C 1285, 277 F. Supp. 472, 371 F. 2d 374, 389 U.S. 332].

Consequently, "if there ever was or could be a case where the circumstances are so extraordinary as to justify the court to take action to defeat injustice" this is

indeed the case. However, as the Court of Appeals recognized, the Petitioner has grievously erred in his perception of the victim.

CONCLUSION

Wherefore, it is respectfully submitted that the Petition for Certiorari should be denied.

Respectfully submitted,

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